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# Stability Pact Reform: A look at "What might have been"<sup>1</sup>

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<sup>1</sup> This paper is an updated version of the paper "Reforming the Pact Without Frightening the Horses" delivered at the annual Dublin Economics Workshop in Kenmare, October 2004. The central feature of it derives from research done by the Author and by Christophe Kamps as part of the Advanced Studies Programme at the Institute of World Economics in Kiel.

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# I Introduction:

## I.a Purpose and structure of the paper

### *Purpose*

There is a French phrase "l'Esprit d'Escaliers" (literally "the spirit of the stairs") that describes a sentiment that is sometimes felt when climbing stairs to bed after having done a hard day's work. It conveys the feeling that the day's work could and should have been done better.

In March of this year, the European Council endorsed proposals from ECOFIN to reform the Stability and Growth Pact, ending a political debate that had surrounded the Pact the suspension of the Excessive Deficit Procedure against France and Germany in November 2003. But although the political debate is over, an analysis of the decisions taken is warranted, particularly given the gravity of Europe's fiscal situation.

As we "ascend the stairs", it is impossible not to feel that the Pact could have been reformed in a much better way: At the time of writing, the Commission is preparing to start disciplinary action against Italy next month because of its rising budget deficit, which it forecasts will exceed three per cent of GDP this year and next. And as shown in table 2 below, the EU's public finances continue to deteriorate.

But it is never enough to criticise. If you complain about the dark, then at least light a candle. In this spirit, the paper outlines how a reform of the Pact could have been constructive, credible and consensual: Two issues have arisen since the Pact's creation in 1996 which together provide a credible reason for reform, i.e. one not open to the charge that the Pact was reformed by politicians for political reasons (a charge that haunts the present reform).

Firstly, EU enlargement has made Europe more fiscally heterogeneous place. Compared to other member states, new member states have higher deficit ratios, but also lower debt ratios and stronger trend growth and thus a higher capacity to absorb those higher deficits. Those higher deficits are broadly proportionate to higher levels capital expenditure, compared to other member states. As developing countries with higher marginal productivity of capital, this is a new fact that should have prompted reform of the Pact regardless of the events of November 2003. Secondly, the attention on the fiscal challenge of ageing in Europe has intensified and strengthened the case for shifting the emphasis of the Pact towards fiscal sustainability<sup>3</sup>.

This paper aims to show how a clear, credible and consistent reform of the Pact could have arisen from these two considerations. It also identifies improvements that needed to be made in the Pact's institutional design.

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<sup>3</sup> A paper commissioned by the Economic Policy Committee to the effect that by 2050 the burden of health and pensions expenditure will rise by around 6 percentage points of GDP for the EU as a whole.

## *Structure of the paper*

Section I of the paper outlines the key features of the Pact that are relevant to its possible reform. Section II gives an account of the crisis in the Pact in November 2003, the build up to it and the various proposals to reform that preceded this crisis. Section III contains the central feature of the paper: It sketches the rationale and outline of an “ideal” reform of the Pact, a reform that could have dealt with the aforementioned issues by relaxing its provisions in relation to medium-term fiscal balances, toughened its provisions in relation to long-term debt and improved some key features of implementation. Section IV concludes.

### 1.b Key features of the Stability and Growth Pact

Three dimensions of the Pact fall to be considered in the context of reform. The first is its substantive purpose; i.e. the fiscal rules it stipulates. The second is institutional design; i.e. the mechanisms by which it aimed to enforce those rules. The third relates to a relevant statistical question.

The substantive rules of the Pact are as follows:

1. Member States must avoid incurring a General Government Deficit in excess of 3.0% of GDP unless this results from either an “unusual event outside the control of the Member State concerned” or from a “severe economic downturn”. The first caveat is not defined in the Pact while the second is defined as an annual fall in real GDP of at least 2 percentage points<sup>4</sup>.
2. Member State must maintain budget balances that when adjusted for the effects of the economic cycle are “Close to Balance or in Surplus” and should avoid fiscal policies which are pro-cyclical – aiming in other words for surpluses in good times and deficits safely within the 3.0% limit in bad times<sup>5</sup>.
3. Member States must maintain General Government Debt levels of below 60% of GDP. However this aspect of the Pact was not implemented and the equivalent stipulation in the Treaty that countries permitted to join the Euro Zone should have debt levels below this threshold did not prevent Belgium, Italy or Greece from successfully joining the Euro with significantly debt levels that were significantly higher.

In terms of its institutional design, the Pact might be seen as having two arms, one preventative and one dissuasive.

The first, preventative, “arm” is constituted by Council regulation 1466/97. This stipulates that Member States will provide Stability Programmes once in EMU on an annual basis, that these will contain medium-term budgetary targets<sup>6</sup> and that these

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<sup>4</sup> If further supportive evidence is available, a decline of 0.75 percentage point or greater in real GDP may also be regarded as a severe downturn.

<sup>5</sup> The Close to Balance or in Surplus criteria for fiscal balances is measured by the Commission with reference to a specified and agreed method for adjusting “headline” General Government Balances for the effects of the economic cycle. For a discussion on the methodology see Denis, McMorrough and Roeger (2002).

<sup>6</sup> These targets must be consistent with the “Close to Balance or in Surplus” criteria of the Pact.

programmes and their implementation will be regularly monitored by the Council and Commission. More importantly, any divergence from sound medium-term budgetary intentions contained in the programmes, or any failure to implement budgetary plans in an acceptable manner will be dealt with by an early warning system.

The second, dissuasive, arm deals with the situation where the preventative arm has failed. It is constituted by Council regulation 1467/97 and is based on article 104 of the Treaty. This regulation defines the "Excessive Deficit Procedure – a procedure which may lead to the imposition of sanctions.

A key issue is that the discretion of imposing sanction rests ultimately with the Council. The German Finance Minister at the time of the Pact's negotiation and conclusion, Theo Waigel, proposed the creation of an independent "Stability Council" to implement the Pact. The Commission raised the difficulty that such an approach would pose from the point of view of infringing the sovereignty of Member States. For this reason, the power of implementing the Pact was left in the hands of the Council.

Finally the statistical interpretation of the Pact deserves brief reference here before being dealt with in section III. Arguments have been made for a looser interpretation of the definition of the General Government Deficit. Giavazzi and Blanchard (2003) note that article 104.3 of the Treaty would in theory permit an interpretation of the Pact to exclude net investment expenditures by reform of Council regulation 1467/97. This issue is relevant to considering the pressures in new member states to invest in public capital.